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August 29, 2007

**Ex Parte**

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

**Re: <u>Petitions for Forbearance from Title II and Computer Inquiries Requirements for Enterprise Broadband Services, WC Docket Nos. 06-125 and 06-147</u>**

Dear Ms. Dortch:

Yesterday, Verizon met with Commissioner McDowell and Mr. John Hunter of his office regarding the above proceedings and responded to follow up questions they had today. Representing Verizon were Ms. Susanne Guyer, Mr. David Small and Mr. Mike Glover, and in the follow-up discussion Ms. Guyer and Mr. Edward Shakin. Verizon reviewed the positions and data presented in its Ex Parte filed in WC Docket No. 04-440 on February 7, 2006 and in the attached report by CIBC. Verizon emphasized the importance when conducting a Broadband analysis of doing so on a national basis, rather than on a local basis, due to the nature of the broadband marketplace. A national analysis for broadband services is also consistent with extensive Commission precedent.

Please let me know if you have any additional questions.

Sincerely,

Dee May

Attachment

cc: Commissioner McDowell
J. Hunter
T. Navin
M. Maher
C. Shewman
D. Stockdale

CIBC World Markets

Equity Research
Industry Update

July 30, 2007

Telecommunications Services

**Sector Weighting:**

**Market Weight**

# Enterprise Outlook Update: Pricing and Volume Continue to Improve

## CLECs Most Positively Leveraged

- We believe the enterprise market is set to reach a 5% revenue growth rate by YE08, from –5% at YE05, driven by stable spot pricing and the repricing of most legacy contracts. This outlook is supported by our industry growth models here, plus updated CLEC financial metrics.
- CLECs should expand their current 20% market share at a 1-2% rate, growing 10%-12%, or double the market rate. CLEC margins, now 20%, should widen by approximately 1% per year on economies of scale, price stability, more efficient technology, and consolidation.
- More difficult long-haul pricing would be a positive for most CLECs. The regulatory environment is improving for CLECs, as are prospects for consolidation (as evidenced by more than 20 mergers in the past two years). We spotlight five private CLECs here.
- Ultimately, we expect to see the emergence of a handful of major CLECs with a national footprint and revenues of $2-3 billion each. Our top CLEC picks are PAET and TWTC, both of which can generate double-digit organic growth in revenue and EBITDA.

*All figures in US dollars, unless otherwise stated.*

07-79713 © 2007



**See "Important Disclosures" section at the end of this report for important required disclosures, including potential conflicts of interest.**

**See "Price Target Calculation" and "Key Risks to Price Target" sections at the end of this report, or at the end of each section hereof, where applicable.**

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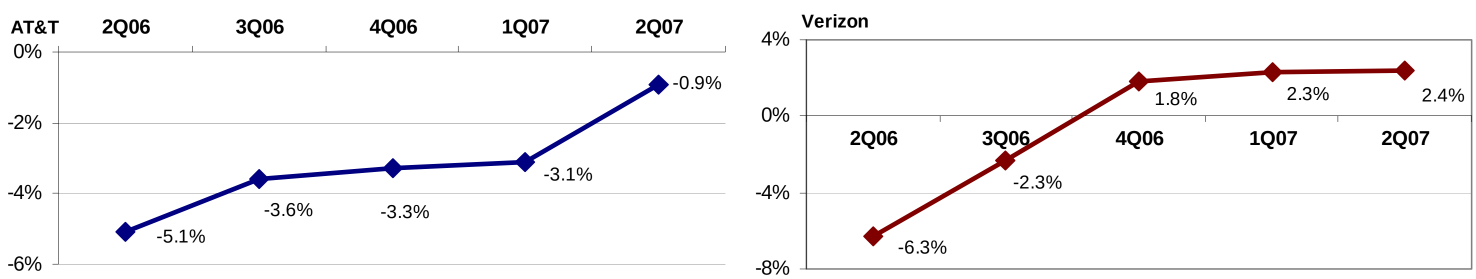
# CLEC Investment Thesis

We believe that enterprise will be the most attractive segment of the communications market over the next five years. Emerging carriers (or CLECs, competitive local exchange carriers) are most positively leveraged to these trends, in our view. The combination of improving pricing trends in the business segment, increased network capacity, and the introduction of differentiated IP communications/ computing services should enable CLECs revenues to grow by 10-12% per year for the next 3-4 years. This would reflect 5% industry growth plus gains of about 1-2% per year in market share.

Pricing improvements come from the consolidation among the large telcos and the long-distance industry and the absorption of the initial impact of IP-driven deflation (this absorption has yet to occur in the consumer market). These trends have enabled fairly stable voice/data spot pricing in the last 18 months. Voice pricing for large enterprises (voice is about half the industry's revenues) is now stable in the 2-3 cent range for long-distance, in our opinion. The improvement in revenue growth can be seen in AT&T/Verizon's results (see Exhibit 1). T is seeing growth not only in small business voice/data revenues, but also in access lines. Data revenue, which continues to grow as a percentage of total business revenue, is now probably close to half, as enterprises "webify."

The incumbents, particularly AT&T, needed to reprice a majority of their enterprise contracts (which usually run for three years), which were on average about 30% above spot prices. Now, this repricing is mostly over and likely to be finalized within the next 12 months. The migration to all IP voice and data services also put pressure on revenue growth, as customers spend about 20% less on telecom services. However, within 12-18 months business customers are back to spending the same amount on communication services. Much of the rebound comes from higher bandwidth and more high-level managed services. As the trend toward Network Centric computing accelerates, these drivers should continue for the next year.

**Exhibit 1. AT&T/Verizon Quarterly Enterprise Revenue Growth (YoY)**




Source: Company reports and CIBC World Markets Corp.

A majority of business customers are now at spot pricing and probably a quarter of business revenues have made the transition to IP. Another, more subtle, drag on revenues has been the grooming of wholesale incumbent traffic. This initiative has hurt both the industry's access revenues as well as wholesale revenues, but we expect it to be completed by year-end.

The current pricing umbrella provided by incumbents is key to the financial health of the CLEC industry. The main CLEC selling point remains differentiated/high quality services/customer care at slightly lower prices. We estimate that CLECs' market share of volume is around 20%, with a revenue market share of 15%. This equates to approximately $13 billion in revenues from the total $90 billion business market opportunity. We believe CLECs could increase their market share to closer to 30%, which would provide almost 10 years of visible growth.

We expect future CLEC revenues to carry high incremental EBITDA margins (i.e., around 50%) for many companies, up from approximately 20% currently for emerging carriers and 35% for the incumbents. Because of this leverage, we expect 10%-12% revenue growth to drive EBITDA growth of 15%. Much of the positive leverage comes from the fact that CLECs have made significant investments in their underutilized networks and operating systems in the past decade. In fact, the industry in total is still trading at less than half investment value. This advantage can be seen in the strong financial results of most CLECs over the past two years. Free cash flow has even more leverage on this 15% EBITDA growth, and should be in the 25% range. Most CLECs are either already FCF positive or are less than a year away from turning cash flow positive.

We believe consolidation in this sector is inevitable, given the economies of scale and scope that it would drive. At present, there are approximately 400 CLECs serving about 21 million business lines (including VoIP). Most of the consolidation to date has taken place through private restructurings. In Appendix 1, we briefly review five private CLECs that have so far assumed the roles of consolidators in their geographic areas. Integra, One Communications, Broadview Networks, NuVox, and TelePacific are all privately owned operators that have managed to expand their footprint through selective acquisitions.

One of the keys to the recent success of the CLEC business model has been the ability to efficiently utilize incumbents' local loops with disruptive technologies. Using IP, VoIP and Ethernet, CLECs can provision lower-cost differentiated services. In addition, the CLECs have provided more targeted marketing, customer care and operating systems, partially as a result of having a focus on discrete segments of the business market (usually either small business, medium-size or, rarely, large business). For the most successful CLECs, this positive combination has come together only in the last few years.

Longer term, we believe successful CLECs will be those that bridge the gap between communications and computing. These carriers will have a dominant horizontal niche (a focus on one customer segment and avoidance of channel conflict), in our opinion.

Long-distance pricing has improved somewhat, in our view, but we still see a few suppliers with substantial amounts of overcapacity, which will likely pressure prices. In this regard, XO Communications announced yesterday that it was increasing its average bandwidth capacity from 400 Gbps to 1,200 Gbps. This is an enormous amount of new capacity, probably equal to all the capacity in Cogent's existing network. This is positive for our top two CLEC picks, for two reasons. First, PAET and TWTC lease long-haul transport in the spot market. Second, we believe that Level 3 will seek to minimize this risk by becoming more vertically integrated and investing in the metro and enterprise markets, probably through consolidation.

We see some near-term risk for the largest CLEC (and one of our top picks), Time Warner Telecom. Some of its short-term risks are the integration of Xspedius and lower than expected carrier/wholesale revenues. Wholesale, which makes up roughly 30% of the company's total top line, declined last quarter due to grooming initiatives by AT&T and Verizon. We expect the two telcos to continue moving traffic aggressively onto their own networks, until the process is completed, or by year-end.

Yet we remain very positive on TWTC's long-term potential as the only independent CLEC with a focus on mid- to large-sized enterprises. In addition, we believe that TWTC could in theory ultimately be acquired. PAETEC, another top pick, is not facing the same risks and is seeing strong fundamental results. PAET will report second quarter results on August 9th.

We reiterate our Sector Outperformer rating on Time Warner Telecom and PAETEC. TWTC is set to leverage its $2 billion-plus network and business model investment. We look for 10% organic revenue growth in 2007, and we believe the company can potentially accelerate this rate in 2009-10 as the overall industry grows. The potential return of wholesale revenue growth could drive EBITDA increases of about 12%. PAET remains one of the few CLECs focused on mid-sized businesses. We expect the company to generate an organic double-digit revenue growth rate and expanding EBITDA margins (going to 22% from 18%) in the next 3-4 years.

**Exhibit 2. Competitive Service Providers' Public Market Multiples**

| | Rating | Closing Price 7/30 | Market Cap. (Mil.) | Firm Value (Mil.) | 2008E Revs (Mil.) | '08 Rev. Mult. | 2007E Revs (Mil.) | Firm Value to 2008E EBITDA Consolidated EBITDA | Multiple | '08 Capex as a % of Revs | 2008E Levered FCF Yield | 2008E Net Debt/ EBITDA |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cogent (CCOI) | SP-S | **$29** | 1,409 | 1,459 | 236 | 6.2x | 188 | 78 | 18.7x | 12.0% | 3.0% | 0.6x |
| Eschelon Telecom (ESCH) | NR | **$29** | 552 | 672 | 371 | 1.8x | 338 | 97 | 7.0x | 16.5% | 3.7% | 1.2x |
| PAETEC (PAET) | SO | **$12** | 1,329 | 2,076 | 1,251 | 1.7x | 1,052 | 244 | 8.5x | 8.0% | 5.4% | 3.1x |
| Time Warner Tel. (TWTC) | SO | **$19** | 2,903 | 3,976 | 1,217 | 3.3x | 1,096 | 426 | 9.3x | 22.0% | 2.7% | 2.5x |
| Cbeyond Comm (CBEY) | NR | **$36** | 1,024 | 990 | 360 | 2.7x | 278 | 61 | 16.3x | 17.4% | (0.2%) | NM |
| Covad Comm. (DVW) | NR | **$1** | 258 | 362 | 547 | 0.7x | 496 | 50 | 7.2x | 4.7% | 9.4% | 2.1x |

Source: Company reports and CIBC World Markets Corp.


CIBC World Markets

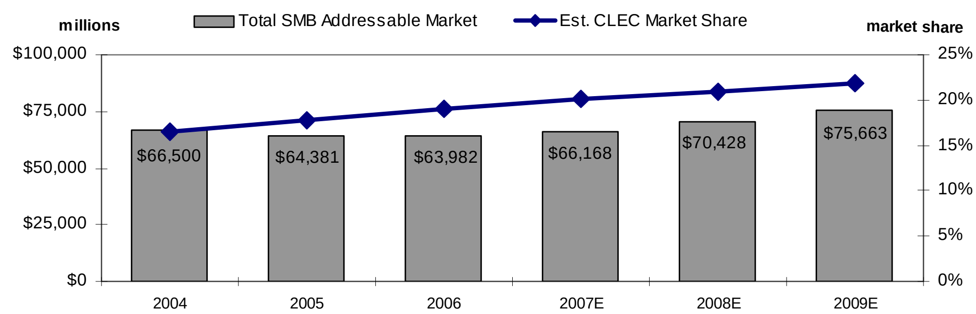
# CLEC Market Overview

We think the horizontally focused companies are best positioned to take advantage of the secular shift to NC computing. These companies either provide critical basic infrastructure (local access, long-haul fiber transport, wireless towers, data centers) or resell the last mile at a profit and provide superior NC applications (e.g., smart-build CLECs, ASPs).

The well-run, well-funded CLECs are in a strong position to gain share in the communications space. Most of these companies exemplify our horizontal segmentation thesis, as they are focused on a specific niche and provide high-quality/innovative services and superior customer support at a lower cost.

Most independent CLECs today, other than Time Warner Telecom, are targeting the $66 billion small- and medium-sized business communication services market (roughly two-thirds of the total business communication services market). CLECs usually provide lower-cost services than incumbents, a better match for the needs of the SMB segment. The large incumbent telcos often have a service/cost advantage in the larger enterprise market, so it makes sense for the competitive carriers to focus on the SMB segment.

**Exhibit 3. SMB Market Size and Estimated CLEC Share (2005-2009E)**



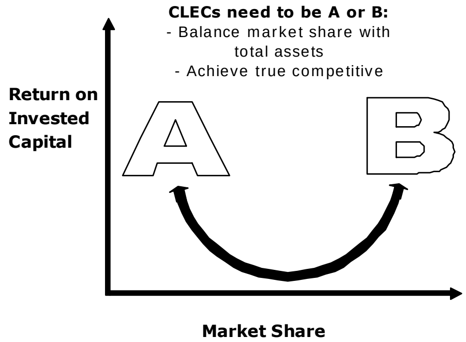

Source: Company reports and CIBC World Markets Corp.

CLECs currently serve about 25% of total business lines, or about 21 million lines. This report focuses on business lines, as the business segment (specifically SMB) remains the primary growth opportunity for CLECs. We estimate that the former AT&T and MCI represented roughly 10% of the 80 million business lines in the U.S. today.

Growing demand for data communications by small- and medium-sized businesses has created an opportunity for service providers and equipment vendors. Even the larger enterprises are relying more on their service provider for value-added applications (e.g., hosted or fully managed offerings, VPNs). This gradual shift toward network-based solutions and reliance on service providers for more than just a land line is creating a new market. CLECs have traditionally focused on value-added services and a more consultative approach to customers, which has allowed the CLECs to gain a respectable share in the newly shaped, services-driven market.

We see two CLEC strategies: 1) offer differentiated applications and competitive prices ("smart-build") and utilize the incumbents' last mile to cost- efficiently connect to the customer or 2) own the last-mile facilities (see Exhibit 4).

## Exhibit 4. Smart-Build vs. Facilities-Based Model




**A. Smart Build - Value-added Marketing Platform**
- Focused strategy
- Variable cost structure
- Outsource most network requirements
- Premium pricing above marginal cost
- Examples: MCLD, PAET, CBEY

**B. Own Facilities - Deploy Dense Networks**
- Scale economies OR differentiate services
- Cover large fixed costs
  - Price = Marginal Cost
  - Premium pricing
- Wholesale infrastructure works best
- Examples: LVLT, TWTC, CCOI

Source: Company reports and CIBC World Markets Corp.

Time Warner Telecom, Level 3, and Cogent are examples of the second approach, facilities-based. These three companies operate unique assets that are difficult (probably impossible) to replicate. However, facilities-based CLECs need high market share to earn their cost of capital, a risky proposition in our view. We see few new CLECs owning last-mile facilities from inception ("build it and they will come" approach) due to the prohibitively high upfront investment needed for a complete network buildout (Level 3 and Cogent are still trading below their overall investment value). Facilities-based companies that have survived and thrived to this point should experience very high incremental returns on invested capital.

The first strategy, smart-build, is more widespread among competitive carriers. Using this strategy, CLECs can meet ROIC hurdles with relatively low market share. PAETEC, Eschelon and Cbeyond have focused on the service component of the business, rather than the delivery infrastructure. CLECs in this group prefer to invest in critical elements of the network (switches) and lease the last mile from the incumbents. The main focus remains on differentiated applications and competitive pricing.

For new start-ups, we prefer a smart-build approach, because it has higher ROIC, lower risk, and more easily takes advantage of new IP-based applications. Under this model, the CLEC captures its customers first and then fills in the needed assets in a cost-effective way. This model was not profitable in the 1990s as there was no efficient way to resell the telcos' last-mile assets. CLECs today are utilizing the incumbents' last-mile infrastructure cost effectively.

# Industry Outlook

**We estimate the size of the total business and enterprise market for voice and data services to be above $90 billion in 2007**. We believe it is poised to grow 3-5% per year for the next three to four years. We estimate the small- to medium-sized business segment at roughly $66 billion in 2007 and believe it is set to grow approximately 4-6% per year, primarily driven by data.

**Exhibit 5. Estimated U.S. Business Voice and Data Market, 2004-2009E**

| | | | | | | | YoY Growth | | | | | '04-'09 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Total Business Lines** | **2004** | **2005** | **2006** | **2007E** | **2008E** | **2009E** | **2005** | **2006** | **2007E** | **2008E** | **2009E** | **CAGR** |
| Circuit Swtiched | 68.1 | 67.9 | 67.2 | 67.2 | 67.9 | 68.6 | -0.3% | -1.0% | 0.0% | 1.0% | 1.0% | 0.1% |
| VoIP | 6.5 | 9.5 | 13.3 | 17.0 | 20.0 | 23.0 | 46% | 40.0% | 28.0% | 17.6% | 15.0% | 28.8% |
| **Normalized Access Lines** | **74.6** | **77.4** | **80.5** | **84.2** | **87.9** | **91.6** | 3.7% | 4.0% | 4.6% | 4.4% | 4.2% | 4.2% |
| **Lines Served by CLECs** | | | | | | | | | | | | |
| Circuit Swtiched | 17.3 | 17.5 | 17.6 | 17.8 | 17.9 | 17.9 | 1.1% | 1.0% | 0.8% | 0.5% | 0.4% | 0.8% |
| VoIP | 1.3 | 1.9 | 2.9 | 4.4 | 6.4 | 8.7 | 45.0% | 52.0% | 55.0% | 45.0% | 35.0% | 46.2% |
| **Total** | **18.6** | **19.3** | **20.5** | **22.2** | **24.3** | **26.6** | 4.2% | 6.0% | 8.4% | 9.4% | 9.6% | 7.5% |
| Voice | $58,900 | $54,407 | $51,541 | $48,946 | $47,587 | $47,415 | -7.6% | -5.3% | -5.0% | -2.8% | -0.4% | -4.2% |
| Data | $36,100 | $36,271 | $37,323 | $41,695 | $47,587 | $53,468 | 0.5% | 2.9% | 11.7% | 14.1% | 12.4% | 8.2% |
| **Total Business Comm. Market** | **$95,000** | **$90,678** | **$88,864** | **$90,641** | **$95,173** | **$100,884** | -4.55% | -2.00% | 2.00% | 5.00% | 6.00% | 1.2% |
| *Est. CLEC Market Share* | *11.6%* | *12.6%* | *13.7%* | *14.7%* | *15.5%* | *16.4%* | | | | | | |
| **Total SMB Addressable Market** | **$66,500** | **$64,381** | **$63,982** | **$66,168** | **$70,428** | **$75,663** | -3.2% | -0.6% | 3.4% | 6.4% | 7.4% | 2.6% |
| *Est. CLEC Market Share* | *16.6%* | *17.8%* | *19.0%* | *20.1%* | *21.0%* | *21.9%* | | | | | | |
| Total Addressable EBITDA | $8,645 | $10,301 | $10,877 | $12,903 | $15,142 | $17,402 | 19.2% | 5.6% | 18.6% | 17.4% | 14.9% | 15.0% |
| *Average EBITDA Margin:* | *13.0%* | *16.0%* | *17.0%* | *19.5%* | *21.5%* | *23.0%* | | | | | | |
| Unlevered Free Cash Flow ($ millions) | $97 | $573 | $561 | $771 | $894 | $1,043 | *493%* | *-2.1%* | *37.4%* | *16.0%* | *16.6%* | 60.9% |
| *Unlevered FCF (% of revenues)* | *0.9%* | *5.0%* | *4.6%* | *5.8%* | *6.1%* | *6.3%* | | | | | | |
| | | | | | | | | | | | | **'04-'09** |
| **CLEC Service Revenue ($ mllions)** | **2004** | **2005** | **2006** | **2007E** | **2008E** | **2009E** | **2005** | **2006** | **2007E** | **2008E** | **2009E** | **CAGR** |
| Local (incl. value added) | $5,125 | $5,259 | $5,489 | $5,860 | $6,346 | $6,919 | 2.6% | 4.4% | 6.8% | 8.3% | 9.0% | 6.2% |
| Long Distance | $2,785 | $2,858 | $2,983 | $3,217 | $3,509 | $3,844 | 2.6% | 4.4% | 7.8% | 9.1% | 9.6% | 6.7% |
| Internet/Data | $2,451 | $2,604 | $2,843 | $3,250 | $3,787 | $4,440 | 6.3% | 9.1% | 14.3% | 16.5% | 17.2% | 12.6% |
| Other (web hosting, VPN, etc.) | $668 | $731 | $821 | $957 | $1,131 | $1,344 | 9.4% | 12.3% | 16.5% | 18.1% | 18.9% | 15.0% |
| **Total Estimated CLEC Revenue** | **$11,030** | **$11,453** | **$12,137** | **$13,284** | **$14,772** | **$16,547** | 3.8% | 6.0% | 9.5% | 11.2% | 12.0% | 8.4% |

Source: Company reports and CIBC World Markets Corp.

We guesstimate that total business lines at the end of 2007 will reach 84 million, growing at a normalized rate of roughly 4% per year. We include circuit-switched and VoIP lines in our estimated total count. We expect circuit-switched lines to grow modestly at around 1% per year in the next three years, while VoIP lines should grow at a healthy rate of 28% in 2007.

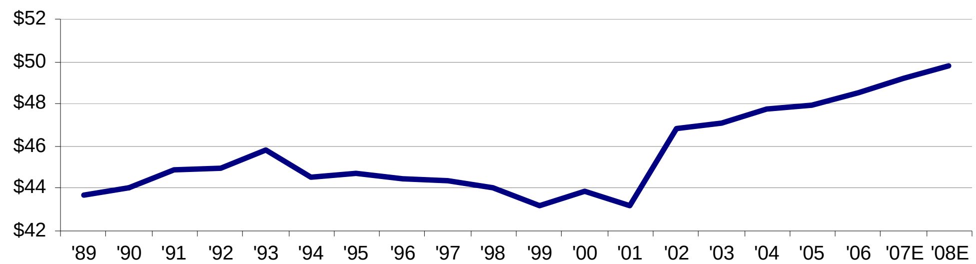
We believe that about 20% of business lines are now VoIP based. These lines can save customers 20% off circuit-switched prices. Large enterprises have been adopting VoIP primarily due to its unique features/functionality.

Most CLECs are focused on small- and medium-sized businesses, which make up roughly 70% of the overall business market. SMBs are the natural addressable market for competitive carriers. We model 4-6% annual growth, which does not include potential NC computing revenues. We think that medium-sized businesses in particular would be more willing to outsource a large portion of their IT needs if they could get good service at a reasonable price.

Average EBITDA margins for seven major CLECs are currently around 17%. While there is substantial deviation, the ones with proven business models are in the 25-30% range (see Exhibit 7). Given strong volume growth and stability in pricing, CLECs should be able to drive their margins by at least 1.5% per year.

If we are correct in our revenue forecast, we should see the CLECs report incremental EBITDA margins in the 40-70% range, depending on the level of imbedded capital investment. Many independent CLECs have difficult-to-replicate, underutilized assets, stable back-office systems and processing capabilities. Importantly, increased demand comes at a time when the number of competitors is at its lowest point in a decade and individual companies have ample excess capacity. Mergers and acquisitions are also driving operating efficiencies and higher margins.

**Exhibit 6. Average Local Revenue per Business Line, 1989-2008E**




Note: Beginning in 2002, additional monthly charges for touch-tone service are included in the monthly charge

Source: FCC and CIBC World Markets Corp.

**Exhibit 7. CLEC Summary Financial Metrics, 2002-2007E**

| | | | | | | | % YoY Growth | | | | | CAGR |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | 2002 | 2003 | 2004 | 2005 | 2006 | 2007E | 2003 | 2004 | 2005 | 2006 | 2007E | '02-07 |
| XO Communication | $ 1,260 | $ 1,110 | $ 1,300 | $ 1,434 | $ 1,412 | $ 1,394 | (11.9%) | 17.1% | 10.2% | (1.5%) | (1.2%) | 2.0% |
| Time Warner Telecom | 696 | 655 | 651 | 706 | 812 | 1,096 | (5.8%) | (0.7%) | 8.6% | 15.0% | 34.9% | 9.5% |
| PAETEC (pro forma) | 540 | 674 | 770 | 897 | 1,125 | 1,251 | 25.0% | 14.1% | 16.5% | 25.4% | 11.2% | 18.3% |
| Integra | 97 | 121 | 138 | 155 | 345 | 383 | 24.3% | 13.8% | 12.3% | 123.3% | 11.0% | 31.5% |
| Eschelon | 122 | 141 | 158 | 228 | 275 | 337 | 15.6% | 12.1% | 44.3% | 20.4% | 22.9% | 22.6% |
| Cbeyond | 21 | 66 | 113 | 159 | 214 | 274 | 212.6% | 73.0% | 40.4% | 34.4% | 28.0% | 67.2% |
| ITC^DeltaCom | 418 | 462 | 584 | 520 | 488 | 487 | 10.3% | 26.4% | (10.8%) | (6.3%) | (0.1%) | 3.1% |
| Cogent | 52 | 59 | 91 | 135 | 149 | 188 | 14.5% | 53.6% | 48.1% | 10.2% | 26.1% | 29.3% |
| **Revenue** | **3,206** | **3,289** | **3,805** | **4,234** | **4,819** | **5,410** | **2.6%** | **15.7%** | **11.3%** | **13.8%** | **12.3%** | **11.0%** |
| | | | | | | | | | | | | |
| **Gross Margin** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007E** | Gross Profit YoY Growth | | | | | |
| XO Communication | 58.5% | 62.0% | 57.5% | 59.0% | 57.7% | 39.1% | (6.6%) | 8.6% | 13.1% | (3.7%) | (33.1%) | (5.9%) |
| Time Warner Telecom | 59.8% | 59.7% | 59.9% | 61.4% | 61.9% | 56.6% | (6.1%) | (0.4%) | 11.4% | 15.9% | 23.4% | 8.3% |
| PAETEC (pro forma) | 54.8% | 56.7% | 55.9% | 52.7% | 45.9% | 48.0% | 29.4% | 12.5% | 9.8% | 9.3% | 16.3% | 15.2% |
| Integra | 62.7% | 65.1% | 66.6% | 67.2% | 69.0% | 69.5% | 29.0% | 16.5% | 13.2% | 129.3% | 11.8% | 34.3% |
| Eschelon | 54.4% | 56.9% | 60.0% | 57.2% | 57.3% | 59.0% | 21.0% | 18.0% | 37.6% | 20.7% | 26.5% | 24.6% |
| Cbeyond | 44.8% | 66.7% | 72.0% | 70.4% | 69.9% | 69.9% | 365.0% | 86.7% | 37.2% | 33.6% | 27.8% | 82.7% |
| ITC^DeltaCom | 53.4% | 50.0% | 49.8% | 51.5% | 49.9% | 52.3% | 3.3% | 26.0% | (7.8%) | (9.2%) | 4.7% | 2.7% |
| Cogent | 5.4% | 20.9% | 30.5% | 36.5% | 46.3% | 55.1% | 339.6% | 124.3% | 77.6% | 39.6% | 50.0% | 106% |
| **Average Gross Margin** | **56.5%** | **58.0%** | **56.6%** | **57.1%** | **55.8%** | **51.4%** | **5.3%** | **12.9%** | **12.1%** | **11.4%** | **3.3%** | **8.9%** |
| | | | | | | | | | | | | |
| **Adj. EBITDA margin** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007E** | Adj. EBITDA YoY Growth | | | | | |
| XO Communication | 0.0% | 0.8% | 1.5% | 7.6% | 6.6% | 10.7% | NM | 120.8% | 441.3% | (14.5%) | 60.7% | 721% |
| Time Warner Telecom | 27.2% | 31.0% | 32.4% | 34.1% | 35.5% | 30.7% | 7.2% | 3.9% | 14.3% | 19.5% | 16.8% | 12.2% |
| PAETEC (pro forma) | 7.7% | 15.0% | 15.5% | 14.5% | 13.7% | 16.2% | 143% | 17.7% | 8.8% | 19.3% | 30.8% | 37.2% |
| Integra | 8.2% | 22.7% | 26.0% | 29.6% | 31.2% | 31.5% | 244% | 30.2% | 27.9% | 135% | 11.9% | 72.1% |
| Eschelon | (2.1%) | 10.0% | 16.2% | 18.0% | 20.2% | 23.7% | NM | 81.1% | 60.9% | 35.3% | 43.9% | NM |
| Cbeyond | (157%) | (6.7%) | 14.5% | 16.0% | 16.4% | 16.1% | NM | (474.4%) | 55.1% | 37.7% | 25.8% | NM |
| ITC^DeltaCom | 27.3% | 12.3% | 11.8% | 14.0% | 12.4% | 13.7% | (50.2%) | 21.3% | 5.3% | (16.7%) | 10.6% | (10.1%) |
| Cogent | (59.1%) | (23.8%) | (13.8%) | 6.0% | 15.0% | 25.6% | NM | (11.3%) | (164%) | 177% | 115% | NM |
| **Average** | **9.0%** | **12.0%** | **12.7%** | **15.9%** | **16.9%** | **19.4%** | **37.0%** | **23.2%** | **38.8%** | **21.5%** | **28.3%** | **29.6%** |
| | | | | | | | | | | | | |
| **Capital Intensity** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007E** | Cap-ex YoY Growth | | | | | |
| XO Communication | 16.6% | 7.4% | 8.2% | 6.0% | 8.4% | 11.8% | (60.5%) | 28.8% | (18.6%) | 37.8% | 38.3% | (4.7%) |
| Time Warner Telecom | 15.1% | 19.8% | 26.4% | 23.0% | 23.3% | 22.8% | 23.8% | 32.3% | (5.5%) | 16.4% | 31.9% | 18.9% |
| PAETEC (pro forma) | 4.8% | 4.3% | 4.3% | 8.1% | 7.0% | 6.8% | 11.5% | 13.8% | 121.2% | 8.1% | 8.2% | 26.8% |
| Integra | 21.6% | 14.7% | 18.5% | 17.5% | 11.9% | 11.8% | (15.2%) | 42.7% | 6.7% | 51.3% | 10.2% | 16.6% |
| Eschelon | 18.9% | 18.4% | 19.6% | 15.8% | 19.9% | 15.9% | 13.0% | 19.2% | 16.1% | 51.8% | (2.0%) | 18.4% |
| Cbeyond | 136% | 40.0% | 21.0% | 18.7% | 20.1% | 19.3% | (7.9%) | (9.4%) | 25.4% | 44.1% | 23.2% | 13.2% |
| ITC^DeltaCom | 8.3% | 9.8% | 8.5% | 5.4% | 9.6% | 11.2% | 30.1% | 9.6% | (42.8%) | 65.5% | 16.6% | 9.5% |
| Cogent | 145% | 40.4% | 11.1% | 12.8% | 14.4% | 14.9% | (68.1%) | (57.8%) | 71.1% | 23.9% | 30.1% | (18.0%) |
| **Average** | **16.3%** | **11.6%** | **11.8%** | **10.9%** | **12.3%** | **13.6%** | **(27.1%)** | **18.5%** | **2.1%** | **29.0%** | **23.5%** | **7.0%** |
| | | | | | | | | | | | | |
| **Un-levered FCF (% rev)** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007E** | Unlevered FCF YoY Growth | | | | | |
| XO Communication | (16.6%) | (6.6%) | (6.6%) | 1.5% | (1.9%) | (1.1%) | (65%) | 17% | (126%) | (219%) | NM | NM |
| Time Warner Telecom | 12.1% | 11.1% | 6.0% | 11.1% | 12.2% | 7.9% | (13%) | (47%) | 102% | 26% | (12%) | 0.6% |
| PAETEC (pro forma) | 2.9% | 10.7% | 11.2% | 6.3% | 6.7% | 9.4% | 360% | 19% | (34%) | 34% | 54% | 49.4% |
| Integra | (13.4%) | 8.0% | 7.6% | 12.1% | 19.4% | 19.7% | (175%) | 7% | 80% | 257% | 13% | NM |
| Eschelon | (21.0%) | (8.4%) | (3.5%) | 2.2% | 0.3% | 7.8% | (53%) | (54%) | (193%) | (82%) | 2,869% | NM |
| Cbeyond | (292%) | (46.7%) | (6.5%) | (2.7%) | (3.6%) | (3.2%) | (50%) | (76%) | (41%) | 82% | 11% | NM |
| ITC^DeltaCom | 19.0% | 2.5% | 3.3% | 8.5% | 2.8% | 2.5% | (85%) | 66% | 127% | (69%) | (10%) | (31.2%) |
| Cogent | (204%) | (64.3%) | (24.9%) | (6.9%) | 0.6% | 10.7% | (64%) | (41%) | (59%) | (110%) | 2,160% | NM |
| **Average** | **(7.3%)** | **0.4%** | **0.9%** | **5.0%** | **4.6%** | **5.8%** | **(105%)** | **165%** | **536%** | **5%** | **41%** | **NM** |

**Notes:**

Estimates for companies not covered by CIBC are from First Call or based on annualized 1Q07 results.
Integra 2006 estimates include ELI acquistion. Eschelon results presented separately.

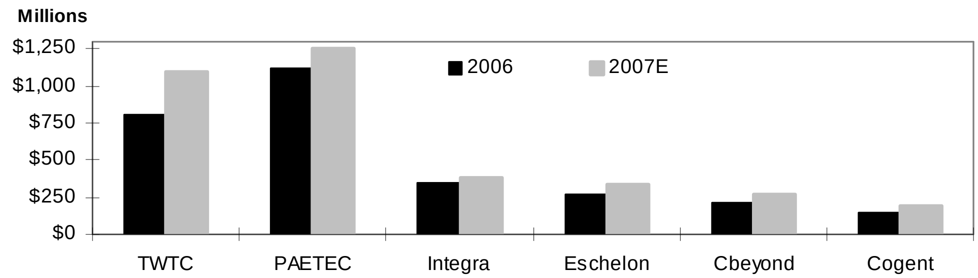
Source: Company reports and CIBC World Markets Corp.

# Investment Positives

## Well-Positioned CLECs Show Solid Operating Leverage

Even with double-digit revenue growth over the past five years, the CLECs we consider to be best positioned have expanded margins and kept cap-ex in check. We estimate emerging carriers, including TWTC, PAETEC, Integra/Eschelon, Cbeyond and Cogent, have grown revenues, both organically and through acquisitions, at a compounded annual rate (CAGR) of 18% over the past five years (vs. the average of 11% for most CLECs).

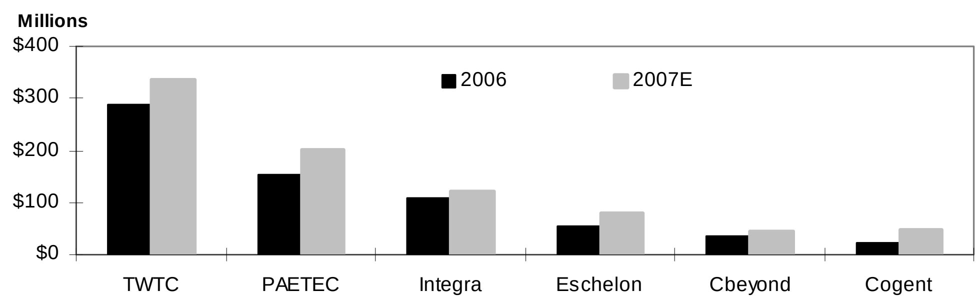
**Exhibit 8. Revenues 2006-2007E**




Source: Company reports, First Call, and CIBC World Markets Corp.

Well-positioned CLECs have grown EBITDA at an estimated CAGR of 40% over the past five years (vs. 30% for the average CLEC), while improving EBITDA margins to 23% of revenues in 2006 from 11% in 2002.

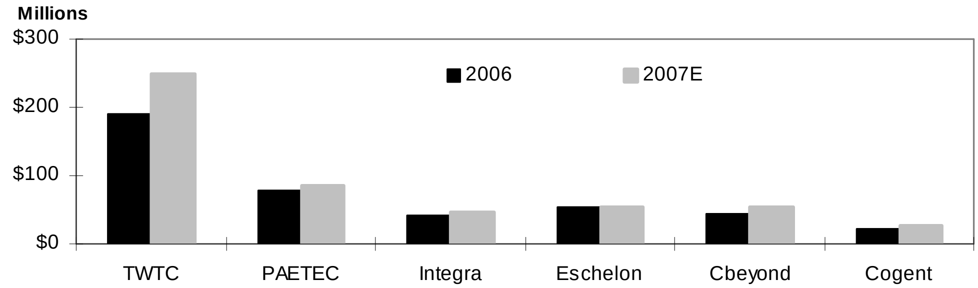
**Exhibit 9. EBITDA 2006-2007E**




Source: Company reports, First Call, and CIBC World Markets Corp.

Cap-ex over the same period has increased at a CAGR of 11%, while cap-ex as a percentage of revenues has declined nearly 360 bps to 15%. While capital intensity is likely to slowly trend down, we expect it will be mostly success driven, based on high incremental returns on capital.

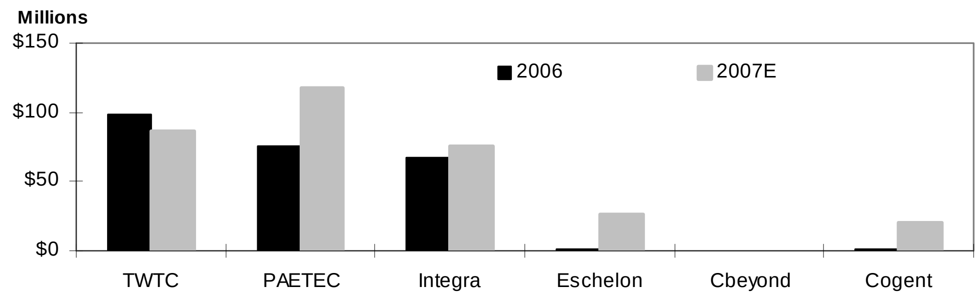
**Exhibit 10. Capital Expenditures, 2006-2007E**




Source: Company reports, First Call, and CIBC World Markets Corp.

Declining cap-ex (as a percentage of revenue) and solid growth in EBITDA have driven unlevered free cash flows (FCF) from a negative $100 million in 2002 to a positive $235 million in 2006. We estimate that from 2003 to 2006, unlevered FCF as a percentage of revenues has expanded from 4% to 8%.

**Exhibit 11. Unlevered FCF, 2006-2007E**




Source: Company reports, First Call, and CIBC World Markets Corp.

# Improving Regulatory Environment

We review regulatory positives and concerns below. We believe the overall regulatory environment gradually shifts to favoring emerging carriers. Our central regulatory thesis in the last decade has been that competition, driven by new technologies, has driven and will continue to drive deregulation. However, over the last four years, under a dominant Republican administration, the incumbent carriers have had unprecedented regulatory wins.

Much of these regulatory wins have been to the detriment of CLECs (UNE-P, non dominant classification, etc.). Given the weak industry fundamentals, this did make some sense, but the administration clearly had laissez faire policies. Now, with the Democrats firmly in control of Congress and potentially the oval office, we think the regulatory environment will become much more difficult. The outcome of this shift is hard to predict, but we expect major telco consolidations to be very difficult and see a shift in regulatory sentiment back to favoring emerging competitors, a clear positive for the CLECs.

**Transition to IP Renders Current Rules Irrelevant:** We also note that there is still a mass of regulation that makes sense only in a circuit-switched context (e.g., access charges, tariffs, billing standards). The ongoing transition to an all-IP world will shortly render most of these rules irrelevant, particularly with VoIP having hit mainstream.

The one piece of regulation that is still critical in an IP world is competitor access to the incumbents' last-mile infrastructure. We believe that at some point the CLECs will have enough market share either to build out some plant themselves or to use wireless technologies, which should force the incumbent telcos to start treating them as valuable customers.

**Last Mile Access Rules Expected to Remain Unchanged:** There is some industry concern that regulators will give the incumbents non-dominant status, and they would then raise rates for UNE-Ls (the first mile copper loops that CLECs resell). Our conversations with industry participants and regulatory representatives lead us to believe that unbundled loops in all their different forms are sacrosanct to regulators and pretty well accepted by incumbents. Our contacts do not point to any overturning of the FCC's decision to keep unbundled loops in place. Further, we expect pricing of wholesale special access UNE T-1s and EELs to remain reasonable and for carriers to continue to look for lower costs through master purchase agreements and network grooming. Despite our optimism, there is still a risk that the incumbents won't need to provision UNE-Ls at some point in the future.

**Forbearance Petitions Threaten Last Mile Access in Competitive Markets:** While we believe that UNE loops availability and pricing are unlikely to change, the major threat is market-by-market forbearance petitions from ILECs. For example Qwest's forbearances for elimination of UNE pricing requirements in Omaha drove average costs per T-1 from $76 to $200. Intense competition from Cox Communications relieved Qwest from providing transmission facilities to competitors. Qwest still provides UNE loops but at "just and reasonable" prices. The company has also petitioned the FCC for similar forbearances in the Denver, Minneapolis, Seattle and Phoenix metropolitan areas.

Verizon is also seeking forbearance from FCC rules on providing some selected network elements, such as last-mile facilities, in six northeast metropolitan service areas.

While the FCC requires that incumbent local exchange carriers continue providing T-1 UNE loops in most situations, this does not cover high-density central offices. If Verizon petition is granted, the price some CLECs pay to obtain access to T-1 loops in the 6 northeast markets will likely increase. We expect such higher costs to be passed on to the end users or pressure margins.

**Telco Copper Plant Retirement:** FCC rules currently permit telcos to retire last mile copper loop facilities without any regulatory oversight. As telcos deploy more fiber infrastructure, which the FCC has declared as not subject to unbundling requirements, telcos may eliminate last mile copper access to customers. To date, Verizon has filed more than 80 notifications of copper plant retirement affecting a few of its exchanges. Several CLECs petitioned the FCC in January 2007 to change copper plant retirement rules. The FCC's consideration of this petition could have longstanding effects on the CLECs' ability to have access to last-mile facilities throughout the country, as "me too" petitions in other markets are likely to follow. The FCC has solicited public comments on this petition but has not yet made any decision. The deadline for FCC to address the Verizon petition is September 2, 2007.

**Wireless Spectrum Auction:** The FCC recently issued its draft rules for the upcoming 700Mhz spectrum auction, which would potentially enable the entry of a wireless wholesale provider. The draft rules are very much in tune with our network-centric computing and horizontal segmentation thesis, but could be detrimental to incumbents and increase competition among CLECs. The valuable, high quality 700Mhz spectrum would likely facilitate the entry of a new national operator.

**TELRIC (Total Element Long-run Incremental Cost) Proceeding:** In 2003, the FCC initiated a proceeding to address the methodology used to price UNEs and to determine whether the current methodology, TELRIC, should be modified. Specifically, the FCC is evaluating whether adjustments should be made to allow incumbent local exchange carriers to recover their actual embedded costs and whether to change the time horizon used to project the forward-looking costs. There has been no progress on the TELRIC rulemaking, and we don't expect significant changes in 2007. Potential ruling could negatively impact CLEC margins.

**Special Access Proceeding:** In January 2005, the FCC released a Notice of Proposed Rulemaking (NPR) in which it considers the adoption of new special access pricing regulations that could potentially result in lower special access prices charged by ILECs or limits to the degree of pricing flexibility ILECs will have. Costs are currently determined by incumbents' special access pricing, which are subject to price-cap rules as well as pricing flexibility rules that permit ILECs to offer volume and term discounts and contract tariffs and remove special access service in a defined geographic area from price-cap regulation based on the competitive landscape.

**Intercarrier Compensation:** An industry task force produced a proposal, the Missoula plan, which was filed with the FCC on July 24, 2006. The Missoula Plan would impose a uniform compensation rate applicable to all types of traffic that a carrier terminates, change the rules of interconnection and transiting, and partially preempt state authority over intrastate access rates. The plan also proposes to establish three tiers of payments whereby large, non-rural wireline and wireless carriers would charge less.

The growing scale and scope of CLECs, in addition to their focus on more dense metropolitan areas, makes them vulnerable to plans aiming to aid the smaller, more rural service providers. The Missoula plan, if adopted as proposed, would result in meaningful reductions in access revenues and increased costs of interconnection for CLECs. Some of the cost increases could potentially be made up by passing them over to customers. Positively, the adoption of any reform would require a long transition period (of at least 3-5 years in our view).

**Changes in USF funding mechanism:** A revised USF may affect the contributions CLECs are required to make to the program (the current contribution is determined as 10.9% of interstate and international revenue). As with the potential increase of last-mile costs, higher USF contributions will either be passed on to end users or compress margins (most likely a combination of both).

**Protections as Part of the Large Telco Merger Conditions:** The transactions between T/SBC, VZ/MCI, and T/BLS have led to favorable for the CLECs merger conditions. Among the key benefits are: extended periods of price caps on special access lines, fixed UNE and private line service rates, commitments not to seek forbearance from the UNE-L and transport obligations, extension of effective interconnection agreements, among others.

**Beneficial Pricing Rules:** CLECs are also obtaining progressively greater pricing flexibility. The number of states no longer reviewing CLEC rates reached 25 this year, versus 21 states where CLEC rates are still subject to flexible regulation (or where price deregulation is dependent on competitive intensity). Another 5 states apply some form of regulation to specific services (e.g. review rates for basic exchange service or require CLECs to set rates at or below those of incumbents).

# Competitive Advantages vs. Telcos

## Quality of Service/Customer Care Drives Market Share

- The very nature of SMBs calls for a more personalized service. Evolving businesses frequently change their communication needs and require more tailored solutions. The incumbents have traditionally had only a direct sales force for larger businesses, as their employee costs are relatively high. The CLECs pay lower success-based commissions and can profit from sales people adding about $3,000 per month in incremental revenues (or roughly $200,000 per year in recurring revenues). In reality, the incumbents never needed to expand their sales force in this segment of the market (primarily relying on call center sales) because they were a virtual monopoly.

- Flexibility to pick and choose the best end-user segments to focus on and the best customers within those segments. For example, the business market usually subsidizes the residential business.

- Ability to deploy differentiated bundles and price them without having to worry about cannibalizing existing services.

- The incumbents still have 75% market share, so there is plenty of room to grow organically.

- CLECs can be more nimble in providing new value-added or IT services.

## Low, Success-Based Costs

- No legacy issues, such as regulatory pricing, operating systems, facilities, retiree healthcare and pension costs, carrier of last resort, etc.

- Unionized employees are not typical for CLECs.

- Smart-build CLECs can capture the customers, then backfill with facilities with very high incremental returns on capital.

# Investment Concerns

The most popular concern among investors remains the prior boom-bust cycle of CLECs and the relatively short period since competitive carriers have become free cash flow positive. We note that CLECs are now using differentiated technologies to sell differentiated communication services with a high degree of customer care (something that appears to be declining at the large telcos). In addition, CLECs are now benefiting from improved pricing environment, changed focus to serving SMBs, and economies of scale.

## Change in Regulation

There are always ongoing proceedings and initiatives that address last-mile resale access and costs. We are more focused on the regulatory issues, as we don't expect new legislation to pass at the federal level in the next few years. The biggest concern here would be either a limitation on interconnection (unlikely), or increased prices for UNE-Ls and special access. We believe the Democratic Congress is protecting new entrants, and if the Democrats win the White House, this will shift to outright assistance, in our view.

## Cable MSOs Represent a Longer Term Risk

The first business services by cable operators are primarily focused on data (e.g., private line services, basic VPNs and high-speed Internet access), with some MSOs planning to commit more resources to the provisioning of voice services later in the year.

Comcast has launched a $3 billion, 5-year plan to enter the SMB market and management expects to capture 20% market share by the end of 2011. The company plans to spend $250 million in 2007. We believe Comcast, which covers 40% of the U.S., poses a threat to CLECs. The company unveiled a new 200-worker business support center in March, specifically dedicated to handling requests of business customers, regardless of their location.

Cox (which serves more than 13,000 businesses in California) and Cablevision are also gaining momentum in the SMB market. Time Warner Cable plans to launch a business voice offering by January 2008.

However, we note that serving the business community demands an increasingly complex set of provisioning and support capabilities. MSOs have historically deployed services in residential markets, and new network buildouts are necessary to meaningfully penetrate the SMB market. MSOs' current business offerings primarily target home offices.

In addition, cable companies need to improve their history of multi-day repair times, as business-critical systems/applications must be repaired in a matter of hours, not days.

Lastly, the small- and medium-sized business customer is typically constrained by a limited budget and IT expertise. SMBs increasingly rely on service providers for hosted or on-demand solutions, avoiding the upfront investment in hardware, and management/maintenance of software. The demand for hosted and managed solutions would require MSOs to include new capabilities in their offerings.

On the whole, we believe the cable companies pose a risk to the CLECs. The MSOs have a clear incentive to service the business market, as this is a highly profitable way to leverage their existing hybrid fiber coaxial networks. However, we expect this will take time to play out, and any meaningful impact is likely a few years away, allowing sufficient time for the CLECs to gain substantial market share and offer a differentiated NC computing service.

## New Entrants/Increased Competition

While we believe barriers to entry are relatively high, a potential drop in the cost of capital could also enable multiple new providers to enter the market, increasing the overall competitive environment.

This is largely what happened with the last CLEC boom/bust cycle. However, given how fresh that bubble is in investors' minds, we do not expect this market to make another irrational turn.

Larger carriers, such as Level 3, XO Communications and Qwest, could increase their investment and focus on providing local services to small- and medium-sized business customers, intensifying the overall competitive environment for the CLECs.

## Unforeseen Disruptive Technologies

Innovation remains the largest risk, potentially introducing more competition. Wireless access technology (e.g. Wi-Fi, WiMAX), in particular, could make many existing business models obsolete. The recent roaming/buildout agreement announced by Sprint and Clearwire is expected to result in a vast footprint, covered with wireless broadband, providing a third high-speed Internet pipe to businesses and consumers.

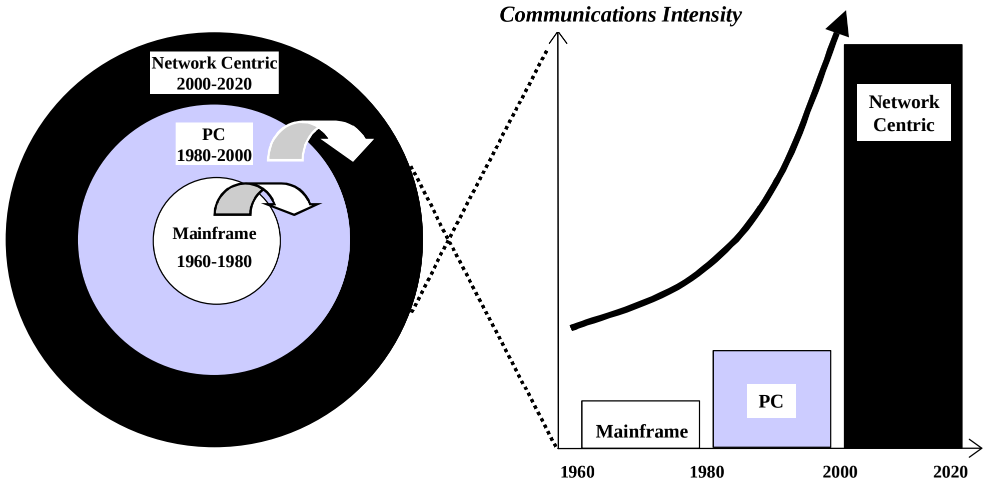
While difficult to predict, wireless or truly differentiated VoIP technologies could substantially lower the cost structure. Low-cost IP transport and voice over IP are largely what drove prices down so much in the last six years.

# NC Computing Drives Growth

We believe the growth of the enterprise communications market will be driven by continued adoption of the network-centric computing model (enabled by ongoing advances in access and transport technologies), horizontal segmentation, pricing power and introduction of new services.

We foresee an economy-wide shift to NC computing, driven by disruptive technologies. Technologies such as IP/Ethernet, soft switches, optronics and wireless broadband are driving traffic onto one multi-purpose IP network that enables new applications (e.g., IT to small businesses) to be purchased separately from network access (e.g., voice and video over IP). These technologies have also increased broadband speeds and reduced latency. In addition, improvements in computing power (Moore's Law), network security (authentication, intrusion detection, encryption, etc.), compression and higher layer protocols are setting the stage for the broad adoption of NC computing.

**Exhibit 12. Communications Intensity**




Source: Company reports and CIBC World Markets Corp.

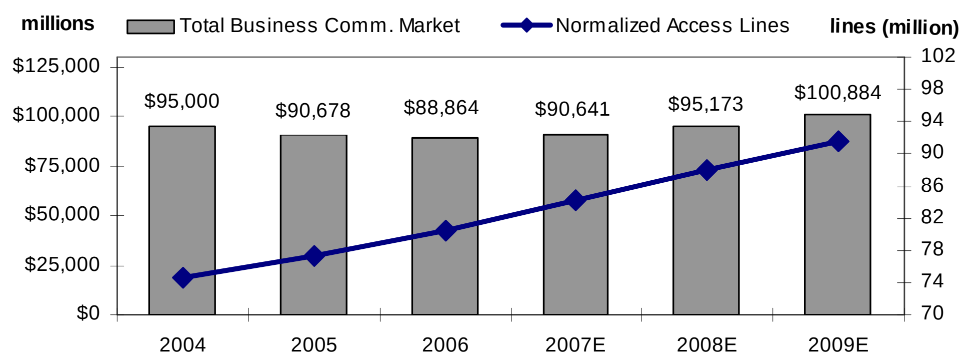
Importantly, the disruptive technologies are enabling, for the first time, the separation of the applications from the underlying physical network. In addition, bottlenecks associated with last-mile broadband and network security are being worked out, mainly due to CLEC competition. On the wireline side, the broadband bottleneck is slowly being resolved by new transport technologies, such as Ethernet, and we believe the small- and medium business market will greatly benefit from this. In wireless, the advent of broadband wireless technologies should be a major driver of NC computing in the next 3-5 years (e.g., 4G, Wi-Fi, WiMAX, etc.). This new access medium should create unpredictable new applications and integration with enterprise data. We expect to see close to a billion wireless devices deployed (in the next few years) that have reasonable broadband capability.

During the 1980s-90s, the U.S. communications market grew revenues at around 6% and earnings closer to 10% per year. Following the burst of the Internet bubble in 2000, revenue growth declined rapidly to negative 3%-4% per year, driven largely by the collapse in pricing power. Pricing declines were caused by abundant excess capacity and a large number of competitors. This oversupply was exacerbated by a deflationary IP technology, numerous bankruptcies, poor customer service and massive enterprise inventories of communications services in the late 1990s.

Following significant restructuring and consolidation during the past few years, we believe pricing power has returned to the industry. This change in trends can be seen in the quarterly performance of AT&T's enterprise revenues (see Exhibit 1 above). We now expect the enterprise communications sector to report 2% revenue growth in 2007 and 5-6% in 2008-09 (see Exhibit 4).

We estimate the total business market has declined from $100 billion to $90 billion in the last five years. We are now looking for the market to grow back to over $100 billion by 2009, or in the 5% range. However, we expect the CLECs' addressable market to grow at a much faster rate, with the CLECs capturing about 1-2% market share per year in the next three to five years. If their market share gains were to accelerate to 4% in the next 2 years, which we consider possible, the incumbents would likely become more aggressive on pricing and/or deployment of new technologies. As a result, the CLECs have a window of opportunity to profitably capture share and offer difficult-to-replicate NC services. While the CLECs will continue to discount prices of legacy services, the focus will be on new solutions and growing the overall market. We believe demand for application service provider (ASP) services will grow dramatically as smaller businesses develop a broader IT infrastructure (supported by cheaper access).

**Exhibit 13. Total Business Market Size 2004-2009E**




Source: Company reports and CIBC World Markets Corp.

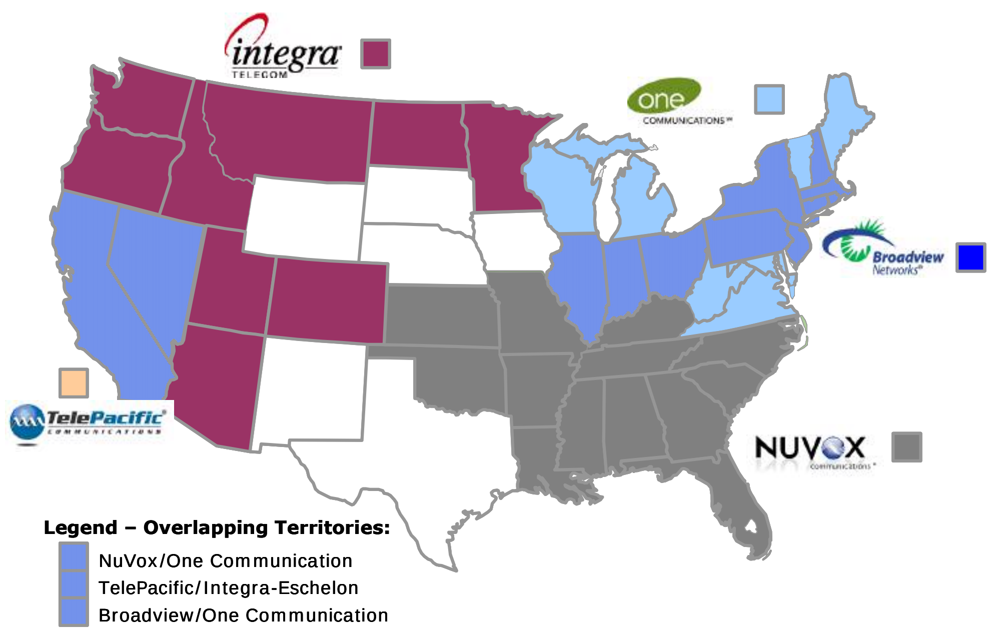
# Appendix 1. Expect More CLEC Consolidation / IPOs

## Consolidation on the CLEC Front

We briefly review five private competitive local exchange carriers (CLECs), which have so far assumed the roles of consolidators in their respective geographic areas. We expect consolidation to continue in the next year or two, and we believe many of these companies will consider becoming public. Ultimately consolidation amongst this group makes strategic/financial sense. Integra, One Communications, Broadview Networks, NuVox, and TelePacific are all privately-owned operators that have managed to expand their footprints through selective acquisitions. The appendix aims to familiarize investors with the operations of the regional consolidators.

At present, there are approximately 400 CLECs serving about 21 million business lines (including VoIP) and 13 million residential switched access lines in the U.S. We believe consolidation in this sector is inevitable, given the economies of scale and scope that it will drive. Technology will also be a key driver of this process, as companies that are leaders in IP services, may seek to acquire customer bases or fiber assets to leverage this skill set. Regulatory pressures may also contribute to consolidation as the telcos win UNE forbearances, which will lead to negotiated prices where scale will be important. Ultimately, we expect to see a few major competitive carriers (i.e. revenues of above $2-3 billion per year) with national footprints.

**Exhibit 14. Five Private CLECs to Keep an Eye on**




Source: Company reports and CIBC World Markets Corp.

Increasing scale of CLEC operations implies better negotiating leverage for last mile access pricing, and growing self sufficiency for local services. Positively, merger conditions in the deals between AT&T and SBC, Verizon and MCI, and more recently AT&T and BellSouth provide short-term protection from ILEC price increases.

Fewer industry players will likely lead to price stability, similar to the dynamics achieved after years of M&A among telcos. Margin expansion is also expected from synergies, as CLECs cross sell each other’s services; centralize billing, customer service, and other corporate operations; and move traffic onto their own networks.

Successful CLECs will seek to focus on targeted niche customer segments, selling highly differentiated services. That's why CLECs have focused primarily on the small- and medium-sized business (SMB) segment, which has historically remained underserved by telcos. The lucrative fundamentals of this $70 billon market have attracted the interest of cable operators and even incumbent telcos. We expect relatively dynamic environment in this space, as CLECs leverage their consultative sales approach to combat increased interest by cable and telco.

CLECs already went down the consolidating path once, with the majority of them going bankrupt. Following the 1996 Act, many competitive carriers went out to expand via M&A, borrowing significant balances to finance such transactions, without adequate earnings to stomach the substantial interest costs. We are now seeing a second wave of consolidation activity, with over 20 significant transactions in the last 1-2 years. The consolidation efforts this time around are more focused on scale and meaningful synergies, with seasoned managements identifying accretive targets and providing disciplined execution.

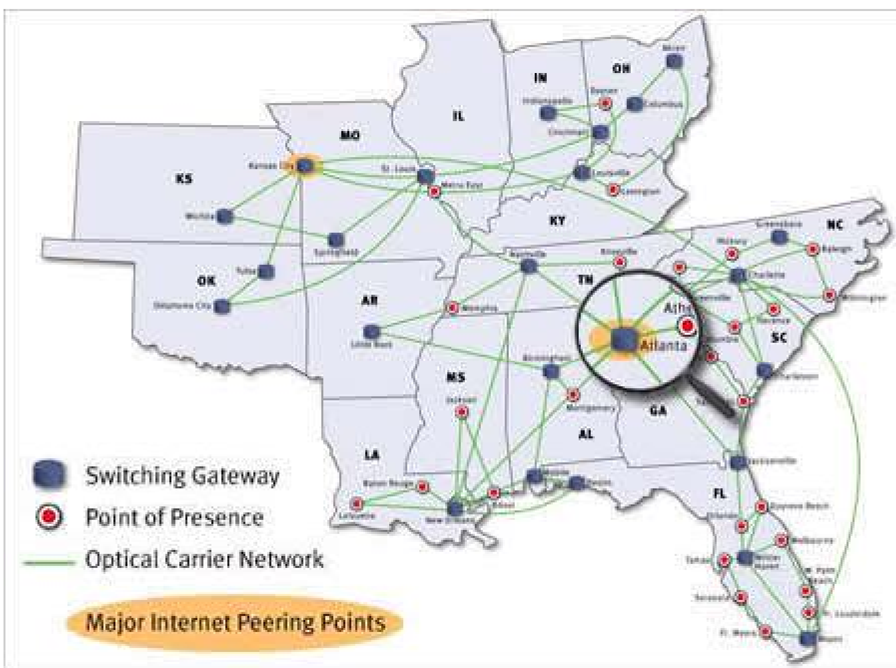
# Five Private Regional Consolidators

## NuVox

NuVox' operations are concentrated in the South East (and Midwest) part of the country. Most recently (3/21), NuVox acquired Florida Digital, becoming one of the largest competitive carrier in the region.

The combined company provides IP-based communications solutions including voice, data connectivity and storage, private networking, web hosting, and security services exclusively to business customers in 16 states. NuVox serves more than 90,000 customers and has approximately 1 million voice and data lines, and annual revenues of above $500 million.

**Exhibit 15. NuVox Serves Customers From 48 Locations in 16 States**



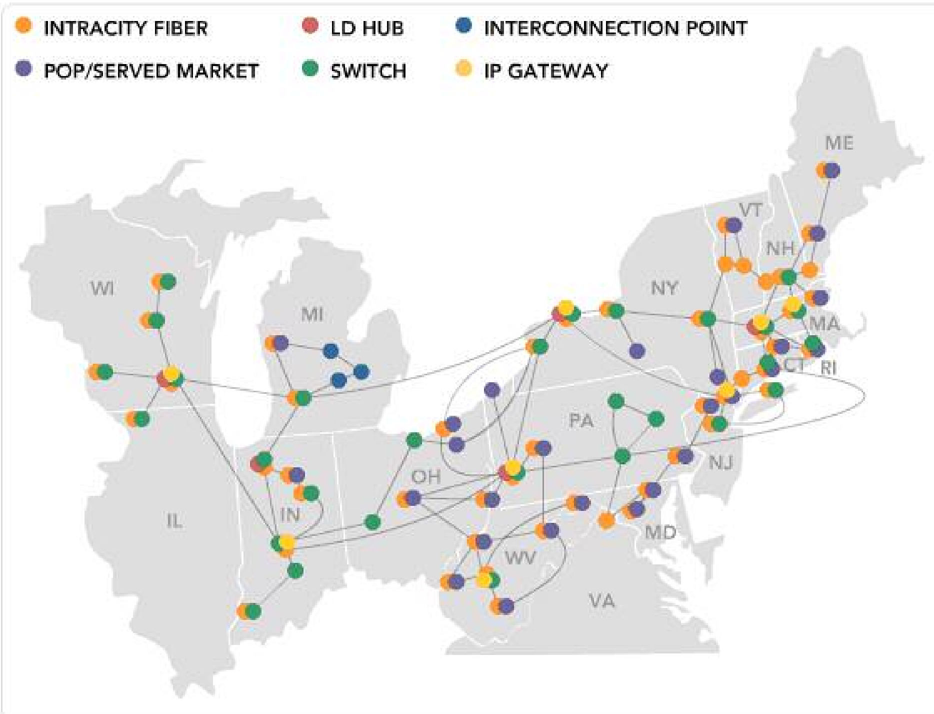

Source: Company reports and CIBC World Markets Corp.

## One Communications

The company significantly increased its scale in one quick stroke – acquiring Conversent Communications and at the same time merging with CTC Communications. The combined entity is a key consolidator in the North East (Mid-Atlantic and Upper Midwest) and probably the largest private competitive carrier in the county.

One Communications serves more than 160,000 businesses in 16 states and employs more than 2,000 people. Annual revenues are approximately $800 million. In addition, the company has valuable infrastructure assets: its IP core uses nearly 10,000 route miles of fiber to interconnect more than 700 collocation sites.

**Exhibit 16. One Comm. Serves Above 160,000 Businesses in 16 States**




Source: Company reports and CIBC World Markets Corp.

## TelePacific

This South-West consolidator most recently completed the acquisitions of Arrival (Feb. 2007) and Mpower (Aug. 2006). The company, established in 1998, serves customers throughout California and Las Vegas, Nevada. TelePacific offers local and long distance voice, dedicated Internet access, private networking and data transport services as well as bundled voice and Internet solutions, to more than 75,000 customers (or 980,000 access lines), primarily SMBs.

TelePacific focuses on maintaining a strong local presence and providing superior customer service – it has more than 1,200 employees across 18 regional offices and three call centers located in CA/NV. The company provides services through a combination of its own switches and network infrastructure, including fiber assets.

In March, TelePacific signed a five-year contract with AT&T for wholesale long distance voice services and special access services for DS1 and DS3 transport. The company has maintained a close working relationship with T since 2003.

Management is headed by CEO Dick Jalkut, who has over 35 years of experience in the telecom industry, including the top executive position at NYNEX, which later merged to create Verizon.

**Exhibit 17. TelePacific Serves 75,000 Accounts in 2 States**


Source: Company reports and CIBC World Markets Corp.

## Integra/Eschelon

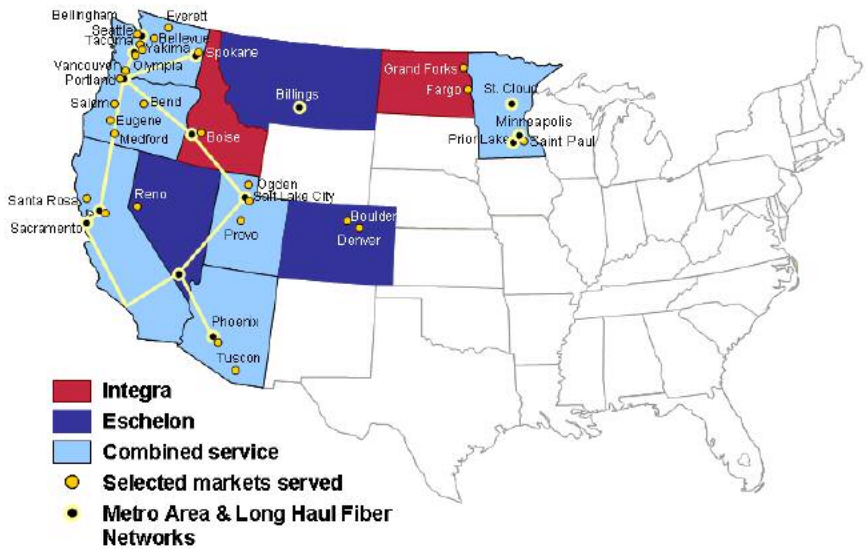
Most recently, Integra announced the acquisitions of Eschelon (March 2007), which is expected to close on August 31, 2007. Upon completion of the transaction, Integra will serve an average of 20% of the businesses in the metropolitan areas in which it operates. Integra focuses on serving the small business market segment with some of the highest quality customer care in the industry. The combined operations will become the largest CLEC in the Western U.S.

The integration of Eschelon is expected to generate substantial operating and network cost savings, as nearly 80% of each company's revenues is derived from overlapping geographic markets. Much of Eschelon's traffic, which was previously routed over leased facilities from other carriers, will now be routed over Integra's extensive metropolitan area and intercity fiber networks. Total combined revenues are expected to be more than $700 million annually, with more than $200 million in pro-forma 2007 EBITDA.

M&A makes up the bulk of the company’s growth since its establishment in 1996. Another of Integra’s significant acquisitions was Electric Lightwave (acquired from Citizens Communications in 2006 for $234 million), which added valuable fiber assets (2,200 route mile metro network, and 4,700-mile long haul network) with direct access to over 580 commercial buildings, effectively reducing the need to lease from incumbents.

Integra’s CEO and co-founder, Dudley Slater, has extensive M&A experience, having served as Principal of Rural Link Communications, a company focused on investing in, and managing ILECs, and as VP of Business Development at Pacific Telecom.

**Exhibit 18. Integra/Eschelon - 11 Western and Midwestern States**




Source: Company reports and CIBC World Markets Corp.

## Broadview Networks

The company, founded in 1996, serves approximately 80,000 SMBs (or over 800,000 access lines) with extended capabilities including an IP platform, metro Ethernet and more than 2,400 route miles of fiber (with over 500 lit commercial buildings). The company's geographic focus is in the Northeast.

Broadview Networks focuses on its expertise in advanced communications solutions and delivers a suite of integrated voice and data services, hosted VoIP applications, and managed network solutions. The company operates 11 switches featuring a core IP platform that supports MPLS throughout the entire footprint and metro-Ethernet capabilities throughout the major network hubs.

Most recently, Broadview completed the acquisition of InfoHighway Communications (provider of hosted and managed communications solutions), after closing ATX Communication in late 2006.

Broadview's CEO, Michael Robinson, spent 7 years as the CFO of the publicly traded competitive carrier US LEC (now part of PAETEC) and 10 years at telecom equipment manufacturer Alcatel.

**Exhibit 19. Broadview Serves 20 Markets in 10 Northeastern States**


Source: Company reports and CIBC World Markets Corp.

# Appendix 2. M&A Transactions in the CLEC Sector

**Exhibit 20. Recent Acquisitions in the CLEC Sector**

| Transaction History at a Glance<br>*($ millions)*<br>Date | Target | Acquirer | Acquisition Value | LTM Revenue | Revenue Multiple |
|---|---|---|---|---|---|
| 7/16/2007 | Yipes Communication | Reliance Comm. | $300 | $70 | 4.3 |
| 7/2/2007 | MobilePro Corp. | United Systems Access | $30 | $63 | 0.5 |
| 3/20/2007 | Eschelon | Integra Telecom | $710 | $275 | 2.6 |
| 2/19/2007 | UNICOM | Eschelon | $14 | $19 | 0.7 |
| 10/17/2006 | Broadwing | Level 3 | $1,400 | 876 | 1.6 |
| 9/22/2006 | Talk America | Cavalier | $251 | $115 | 2.2 |
| 8/14/2006 | PAETEC | US LEC | $1,300 | $1,000 | 1.3 |
| 8/9/2006 | OneEighty Communications | Eschelon | $10 | $7 | 1.3 |
| 7/30/2006 | Xspedius Communications | Time Warner Telecom | $532 | $240 | 2.2 |
| 6/29/2006 | Mountain Telecommunications | Eschelon | $40 | $19 | 2.1 |
| 6/6/2006 | Looking Glass | Level 3 | $165 | $77 | 2.1 |
| 5/15/2006 | OnFiber Communications | Qwest | $107 | $60 | 1.8 |
| 5/5/2006 | Mpower Communications | TelePacific Comm | $204 | $193 | 1.1 |
| 5/2/2006 | TelCove Inc. | Level 3 | $1,238 | $390 | 3.2 |
| 4/14/2006 | ICG Communications | Level 3 | $163 | $77 | 2.1 |
| 2/7/2006 | Electric Lightwave | Integra Telecom | $247 | $159 | 1.6 |
| 1/27/2006 | Oregon Telecom | Eschelon | $20 | $24 | 0.8 |
| 1/26/2006 | Progress Telecom | Level 3 | $140 | $70 | 2.0 |
| 12/30/2005 | Eventis Telecom | Hickory Tech | $36 | $43 | 0.8 |
| 12/23/2005 | WilTel Communications | Level 3 | $724 | $1,550 | 0.5 |
| 12/13/2005 | New Edge Networks | EarthLink | $144 | $120 | 1.2 |
| 12/6/2005 | ConEdison Communications | RCN | $32 | $42 | 0.8 |
| 10/5/2005 | NextWeb | Covad | $25 | $8 | 3.1 |
| 1/4/2005 | American Long Lines | PAETEC | $4 | $25 | 0.2 |
| 10/22/2004 | ICG Communications assets | Mpower Comm | $14 | $30 | 0.5 |
| 10/19/2004 | Advanced TelCom | Eschelon | $46 | $80 | 0.6 |
| 3/8/2004 | Focal Communications | Corvis | $210 | $280 | 0.8 |
| 3/3/2004 | GoBeam | Covad | $48 | NA | NA |
| 2/13/2004 | Allegiance Telecom | XO Communications | $660 | $770 | 0.9 |
| | | | | **Average** | **1.47** |

Source: Company reports and CIBC World Markets Corp.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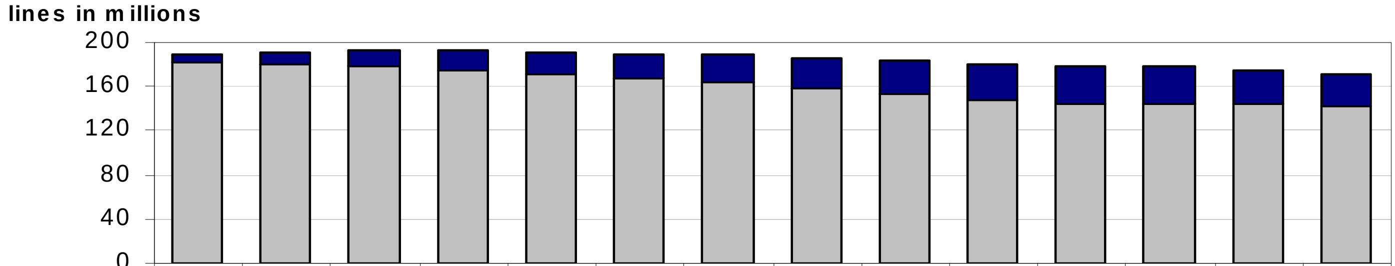
# Appendix 3. CLEC vs. ILEC Line Metrics

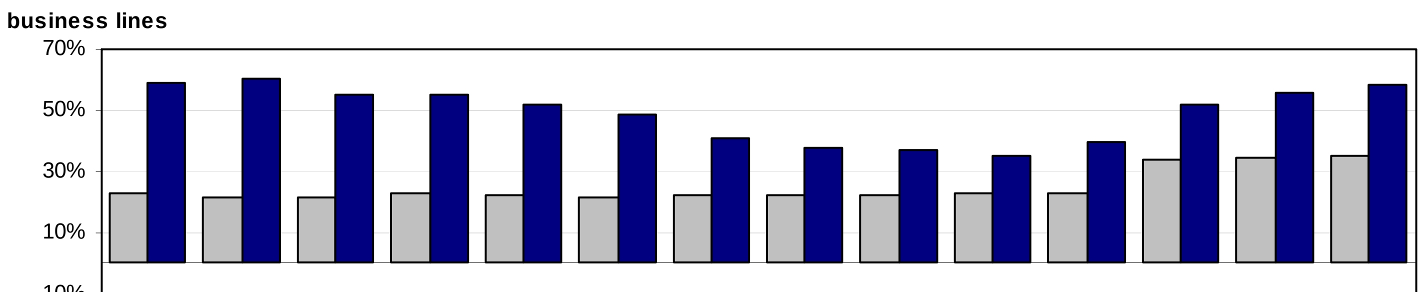
### Exhibit 21. Reported End-User Switched Access Lines




| | Dec 1999 | Jun 2000 | Dec 2000 | Jun 2001 | Dec 2001 | Jun 2002 | Dec 2002 | Jun 2003 | Dec 2003 | Jun 2004 | Dec 2004 | Jun 2005 | Dec 2005 | Jun 2006 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| CLEC Lines | 8.2 | 11.6 | 14.9 | 17.3 | 19.7 | 21.6 | 24.9 | 27.0 | 29.8 | 32.0 | 32.9 | 34.0 | 31.4 | 29.8 |
| ILEC Lines | 181.2 | 179.6 | 177.6 | 174.8 | 171.9 | 167.3 | 164.4 | 158.3 | 153.2 | 148.0 | 144.8 | 143.8 | 143.8 | 142.2 |

Source: Federal Communications Commission reports and CIBC World Markets Corp.

### Exhibit 22. % of Switched Access Lines that Serve Business Customers

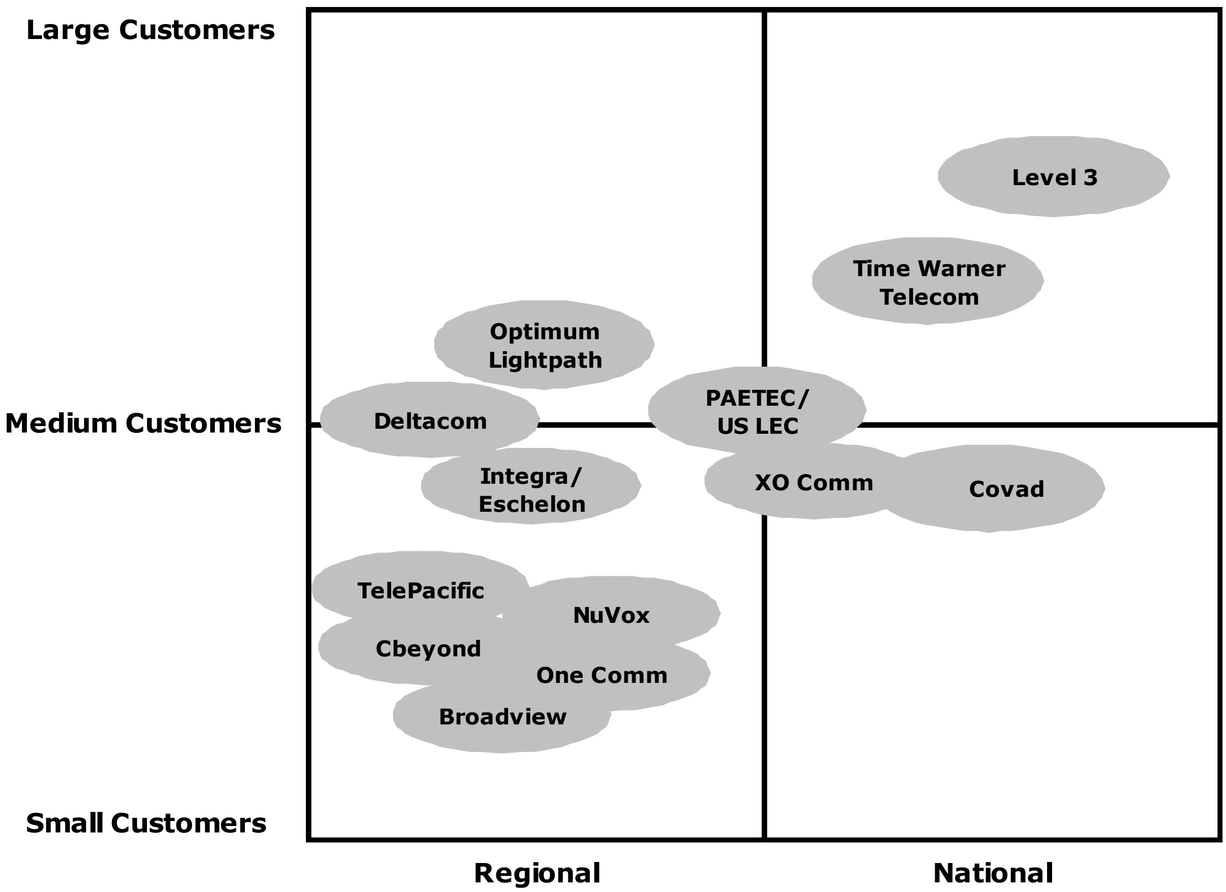



| | Dec 1999 | Jun 2000 | Dec 2000 | Jun 2001 | Dec 2001 | Jun 2002 | Dec 2002 | Jun 2003 | Dec 2003 | Jun 2004 | Dec 2004 | Jun 2005 | Dec 2005 | Jun 2006 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ILECs | 22.9% | 21.8% | 21.8% | 23.0% | 22.5% | 21.7% | 22.4% | 22.6% | 22.5% | 22.6% | 22.6% | 33.7% | 34.3% | 35.0% |
| CLECs | 58.9% | 60.4% | 55.5% | 54.9% | 51.7% | 48.8% | 41.2% | 37.9% | 37.2% | 34.8% | 39.7% | 51.9% | 55.8% | 58.5% |

Source: Federal Communications Commission and CIBC World Markets Corp.

# Appendix 4. Coverage and Business Size Matrix

**Exhibit 23. CLECs' Business Size vs. Geographic Coverage**




Source: Company reports and CIBC World Markets Corp.

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Comcast (1) (CMCSA-OTC, US$27.21, Sector Outperformer)
EarthLink, Inc. (1, 2f, 3a, 3b) (ELNK-OTC, US$7.02, Sector Underperformer)
Eschelon Telecom Inc. (1, C49) (ESCH-NASDAQ, US$29.29, Not Rated)
Level 3 (1, 2a, 2d) (LVLT-OTC, US$5.22, Sector Performer - Speculative)
PAETEC Holding Corp. (1) (PAET-NASDAQ, US$11.91, Sector Outperformer)
Qwest Communications (5a) (Q-NYSE, US$8.64, Sector Performer)
Sprint Nextel (S-NYSE, US$20.93, Sector Performer)
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Covad Communications (DVW-AMEX, US$0.88, Not Rated)
Hickory Tech (HTCO-OB, US$8.88, Not Rated)
ITC DeltaCom Inc (ITCD-OTC, US$1.16, Not Rated)
PPL Corporation (PPL-NYSE, US$46.92, Not Rated)
RCN Corp. (RCNI-OTC, US$17.69, Not Rated)
Telephone Data Systems (TDS-NYSE, US$68.40, Not Rated)
Time Warner Cable (TWCAV-NYSE, US$38.00, Not Rated)
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C49 CIBC World Markets Corp. will be providing debt financing to Integra Telecom, Inc. in its announced acquisition of Eschelon Telecom, Inc. (ESCH).

# CIBC World Markets Price Chart

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|---|---|---|---|---|---|
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| Sector Performer (Hold/Neutral) | 448 | 48.9% | Sector Performer (Hold/Neutral) | 224 | 50.0% |
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| Restricted | 23 | 2.5% | Restricted | 23 | 100.0% |

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|---|---|---|---|---|---|
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| Sector Performer (Hold/Neutral) | 14 | 51.9% | Sector Performer (Hold/Neutral) | 5 | 35.7% |
| Sector Underperformer (Sell) | 1 | 3.7% | Sector Underperformer (Sell) | 1 | 100.0% |
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